

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
CALIFORNIA 6 MOTELS AND)
WESTERN 6 MOTELS)

For Appellants: Jack B. Campbell
Vice President

For Respondent: Noel J. Robinson
Counsel

O P I N I O N

These appeals are made pursuant to section 25666^{1/} of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of California 6 Motels against a proposed assessment of additional franchise tax in the amount of \$1,288 for the income year 1977, and on the protest of Western 6 Motels against a proposed assessment of additional franchise tax in the amount of \$4,083 for the income year 1978.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the years in issue.

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The sole **issue for** determination in these appeals is whether appellants were entitled to use the lower range variance of an asset guideline period provided under the Asset Depreciation Range (ADR) system of determining the useful life of an asset for purposes of **depreciation.**

Appellants are closely held California corporations which filed their franchise tax returns on a calendar-year basis under an accrual method of accounting. During the years under review, the stock of both corporations was owned by the same two individuals who acted as the president and the secretary of each company. The principal business of the taxpayers was the operation of budget motels.

Between 1970 and 1977, appellant California 6 Motels owned and operated a chain of motels located entirely in this state. In January 1978, however, a corporate merger or consolidation apparently resulted in the absorption of California 6 Motels and its assets into its sister company, Western 6 Motels. Formed in 1972, appellant Western-6 **Motels** for six years had conducted its motel business wholly outside of California. Following the merger in 1978, appellant Western 6 Motels thus began operating a chain of budget motels located within and without California. Consequently, it was required to determine **its** California-source income by formula apportionment.

Appellant California 6 Motels on its franchise tax return for 1977 and appellant Western 6 Motels on its franchise tax return for 1978 each claimed deductions for depreciation of motel furniture and furnishings. On their respective returns, appellants elected to apply the ADR system for computing a reasonable allowance for depreciation of this personal property of their businesses.

Upon audit, respondent determined **that appellants'** claimed depreciation deductions were based upon appellants' selection of an eight-year useful life for the motel furniture. Respondent noted that this was the lower limit of the asset depreciation range established by federal regulations for this type of asset. Respondent then recalculated the annual allowances for depreciation of appellants' motel furniture based upon the depreciation period of ten years and reduced the amounts of the claimed deductions accordingly. The proposed assessments of additional franchise tax at issue in these

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appeals reflect these adjustments made in appellants' depreciation deductions.

In these appeals, it is respondent's position that, **if** a taxpayer elects to use the ADR system, it may not for California tax purposes choose a useful life from the range of available asset depreciation lives provided by federal regulations for its class of assets. **Respondent** contends that appellants as California taxpayers were limited by state regulation to the asset guideline period without regard to any variances,

Section 24349 allows **as** a depreciation deduction a reasonable allowance for the exhaustion, wear **and** tear (including a reasonable allowance for obsolescence) of property used in a trade or business. The annual allowance for depreciation is based, in part, on an estimate of the property's **useful** life, i.e., the period over which the asset may reasonably be expected to be useful to **the taxpayer** in its trade or business. (Cal. Admin. Code, tit. 18, reg. 24349(a), subd. (2).)

In 1977, by reference to the pertinent Treasury regulation, California adopted the federal ADR system of depreciation for property placed in service after December 31, 1970, subject to certain exceptions. (Cal. Admin. Code, tit. 18, reg. **24349(1)**; Appeal of Bart C. and Doreen M. Rainone, Cal. St. Bd. of Equal., May 8, 1984.) Under the federal regulation, a taxpayer must make an annual election to apply the ADR system to all additions of eligible property acquired during the taxable year of election. (Treas. Reg. **§ 1.167(a)-11(a)(1)**.) Any depreciable, tangible **property** is eligible for ADR treatment so long as there is an "asset guideline class" and "asset guideline period" in effect for such property. (Treas. Reg. **§ 1-167(a)-11(b)(2)(i)**.)

The ADR system **operates** by prescribing asset guideline periods or useful lives to assets which are categorized according to industries.- The class lives provided reflect the estimated useful lives for all the different assets which may be found in particular businesses. (4 Mertens Law of Federal Income Taxation, **§ 23.04e** (1980 Revision).) If its assets fall within a designated **asset guideline** class, a taxpayer under the federal ADR system can elect an asset depreciation period from a range of useful lives established for that class of assets. (Treas. Reg. **§ 1.167(a)-11(b)(4)(i)**.) This asset depreciation range may vary 20 percent from the

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asset guideline period, extending from 80 percent to 120 percent of the asset guideline period. (Int. Rev. Code, § 167(m); Treas. Reg. § 1.167(a)-11(b)(4)(i).) Thus, for example, "assets used in the provision of personal services such as those offered by **hotels** and motels" have an asset guideline period of ten years with an asset depreciation range from eight to twelve years. (Rev. **Proc.** 72-10, 1972-1 C.B. 721; Rev. **Proc.** 77-10, 1977-1 C.B. 548, 567.)

However, one of the areas where the California ADR system differs from the federal system lies in the applicability of this 20-percent. range variance for each asset guideline period. The California regulation unequivocally states, in pertinent part, that use of this variance element of federal ADR system is not permitted: "The permissible asset depreciation period- for any asset guideline class shall be the asset guideline period without any range or variance." (Cal. Admin. Code, tit. 18, reg. 24349(1), subd. (1)(A).) It is well settled that **respondent's** determination of 'a proper depreciation allowance carries with it a presumption of correctness, and the burden of showing the determination to be incorrect is on the taxpayer. (Appeal of Peninsula Savings and Loan Association, Cal. St. Bd. of Equal., Jan. 2, 1974; Appeal of John W. and Jean R. Patierno, Cal. St. Bd. of Equal., June 30, 1980.) Here, respondent determined that appellants in computing their depreciation allowance under the ADR system deviated from the specific language of the state regulation. The asset guideline period prescribed for assets used in the motel business is ten years and appellants employed the lower limit of the asset depreciation range. Appellants contend, however, that an eight-year useful life is closer to the actual useful life of their business furniture and furnishings. Appellants state that this property must be replaced every six to eight years due to the constant high occupancy and turnover rates in their budget motels. Appellants take the position that, if the Franchise Tax Board can unilaterally change their method of depreciation, then they should be allowed to use the shorter, actual useful life of the property in calculating proper depreciation allowances.

Appellants' argument is not well taken. Because they elected to apply the ADR system, appellants were bound to follow the state regulation mandating use of the asset guideline period without resort to any variances within the asset depreciation range.. Respondent did not

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modify appellants' method of depreciation but simply applied the only permissible useful life available to appellants under the ADR system as adopted by- this state. Moreover, once made, appellants may not revoke their elections with respect to the subject property by conveniently ceasing to apply the ADR provisions. (Treas. Reg. **§ 1.167(a)-11(a)** and (b)(5)(i); Rev. Rul. 82-22, 1982-1 **C.B. 33.**)

We, therefore, find that respondent properly determined appellants' depreciation allowances under the **ADR** system for the years in question. Accordingly, respondent's action in this matter must be sustained.